STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
Proposed General Increase in	)	Docket No. 14-0224
Rates for Gas Service	)	
	)	
THE PEOPLES GAS LIGHT AND COKE COMPANY	)	
Proposed general increase in	)	Docket No. 14-0225
Rates for Gas Service	)	

DIRECT TESTIMONY OF DAVID J. EFFRON ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS

July 2, 2014

AG EXHIBIT 1.0

NORTH SHORE GAS COMPANY
THE PEOPLES GAS LIGHT AND COKE COMPANY
DOCKET NOS. 14-0224, 14-0225
TESTIMONY OF DAVID J. EFFRON

TABLE OF CONTENTS

EXHIBIT LIST

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty-five years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings and other utility matters?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in numerous cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University.

II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the People of the State of Illinois represented by the Attorney General ("AG").

Q. What is the purpose of your testimony?

A. I am recommending adjustments to the rate base and test-year operating expenses for the North Shore Gas Company ("North Shore" or "NS") and Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") (together "the Companies") in these rate cases, based on my review and analysis of the Companies' presentations. I have also calculated the revenue deficiency, or excess, for North Shore and Peoples Gas based on the return on common equity authorized by the Commission in Docket Nos. 12-0551 and 12-0552. I have not reviewed the testimony of Commission Staff or other intervenors in the preparation of my testimony. My testimony is based on issues that I have identified, and I do not take a position on any issues in this testimony that they may raise in the determination of rate base or operating expenses.

III. REVENUE REQUIREMENT ISSUES

A. TESTIMONY ORGANIZATION AND SUMMARY

Q. How is your testimony organized?

A. I first address issues affecting the determination of the rate base and then issues affecting the determination of pro forma expenses. My rate base adjustments are summarized on my Schedules DJE NS B and DJE PGL B, and my operating expense adjustments are summarized on my Schedules DJE NS C and DJE PGL C.

Q. What revenue deficiency or excess have you calculated?

A. Based on the test year consisting of the 12 months ending December 31, 2015, I have calculated jurisdictional rate base of $210,506,000 and pro forma jurisdictional operating income under present rates of $14,351,000 for North Shore. With a cost of equity of 9.28%[1], as authorized by the Commission in Docket No. 12-0511, North Shore presently has an operating income excess of $609,000, which translates into a revenue excess of $1,022,000 under present rates (Schedule DJE NS A).

Based on the same test-year, I have calculated jurisdictional rate base of $1,668,575,000 and pro forma jurisdictional operating income under present rates of $82,392,000 for Peoples Gas. With a cost of equity of 9.28%[2], as authorized by the Commission in Docket No. 12-0512, Peoples Gas presently has an operating income deficiency of $32,164,000, which translates into a revenue deficiency of $54,751,000 under present rates (Schedule DJE PGL A).

In calculating the Companies' revenue requirements, I have not taken into account any potential effects of the recently announced acquisition of Integrys Energy Group, Inc. ("Integrys") – the parent of North Shore and Peoples Gas - by Wisconsin Energy Corp. The merger announcement of June 23, 2014 makes reference to "operational and financial benefits" that are "clear, achievable and compelling" and

[1] I make no assessment in my testimony as to whether this is an appropriate return on equity for the North Shore.
[2] I make no assessment in my testimony as to whether this is an appropriate return on equity for Peoples Gas.

states that the transaction will be “accretive to Wisconsin Energy's earnings per share in first full calendar year after closing.” The anticipated closing for the merger is summer of 2015, which is the middle of the test year in this case. It is unclear the extent to which the Companies’ costs of service will be affected by the “operational and financial benefits” referenced in the merger announcement or the extent to which these benefits should be incorporated into the determination of the Companies revenue requirements and rates. The Companies should describe and quantify the expected operational and financial benefits of the proposed merger in their Rebuttal testimony and should explain why it would or would not be appropriate to incorporate those expected operational and financial benefits into the determination of their test-year revenue requirements.

B. RATE BASE

1. Utility Plant

Q. How did the Companies determine the balance of gross utility plant that they are proposing to include in their rate bases?

A. The gross utility plant included in rate base is the forecasted average plant balance in 2015, the test year in this case. The Companies began with the actual balances of plant as of June 30, 2013 and then adjusted those balances for forecasted additions to and retirements from plant for the last six months of 2013 and calendar years 2014 and 2015.

Q. In calculating its 2015 test-year rate base, how did Peoples Gas treat plant additions associated with its Qualifying Infrastructure Plant ("QIP") program?

A. As explained by PGL Witness Derricks, Peoples Gas' new Rider QIP was approved by the Commission's final Order in ICC Docket No. 13-0534 and became effective January 1, 2014. Rider QIP allows dollar-for-dollar recovery of return on the net investment in QIP expenditures and depreciation expense on that plant. In determining its 2015 test-year revenue requirement, Peoples Gas included QIP in the forecasted plant balances but then removed the net investment in 2015 QIP from rate base and the depreciation on that plant from 2015 test-year expenses by means of pro forma adjustments, assuming that the associated revenue requirement will be recovered through Rider QIP. This avoids any disputes about the accuracy of the forecast of 2015 QIP additions. However, Peoples Gas included forecasted 2014 QIP additions in its 2015 test-year rate base and depreciation on that plant in 2015 test-year expenses.

Q. Does the inclusion of the 2014 QIP plant additions in Peoples Gas' rate base have a material effect on its test-year revenue requirement?

A. Yes. The 2014 QIP additions increase Peoples Gas' 2015 test-year rate base by approximately $280 million and its test-year depreciation expense by approximately $7 million. The effect is to increase the 2015 test-year revenue requirement by over $35 million.

Q. Is Peoples Gas actually adding QIP to plant in service in 2014 at its forecasted rate?

A. No. Based on the response to Data Request PGL AG 11.04, the actual additions to plant in service for the accelerated main replacement program ("AMRP," which accounts for 85% of QIP) through May 2014 were approximately $22.6 million. The average monthly AMRP additions to plant in service were $4.5 million, which translates into annual plant additions of approximately $54 million. This compares to the Peoples Gas forecast of $227 million of 2014 AMRP additions to plant in service (response to Data Request PGL AG 3.02).

Q. Should the balance of 2014 QIP additions included in the Peoples Gas rate base be modified?

A. Yes. The 2014 QIP additions included in the test-year rate base should be reduced to a balance that is more consistent with the actual experience in 2014 to date. Making such a reduction to the forecasted 2014 QIP additions poses little, if any, risk to Peoples Gas.

In response to Staff Data Request DLH 11.01, Peoples Gas stated that "If actual 2014 QIP additions are greater than the amount approved in base rates per the Final Order, Peoples Gas will include that difference in the calculation of the first QIP Surcharge Percentage filed after base rates go into effect. This difference will be added to the actual QIP additions as they are placed in service in 2015."

In the response to Staff Data Request DLH 11.02, as corrected in the response to Data Request PGL AG 3.04, Peoples Gas stated that "If actual 2014

QIP additions are less than the amount approved in base rates per the Final Order, Peoples Gas will include that difference in the calculation of the QIP Surcharge Percentage(s) filed after base rates go into effect. Until this difference is exceeded by the actual QIP additions as they are placed in service in 2015, the QIP Surcharge Percentage will equal zero, except for any reconciliation adjustment (charge or refund)."

Based on these responses, if the actual 2014 QIP additions are greater than the forecast (which seems unlikely), Peoples Gas will recover the incremental revenue requirement effect of the excess additions in the QIP Rider. On the other hand, if the actual 2014 QIP additions are less than the forecast, Peoples Gas' base rates will recover a revenue requirement for 2014 QIP additions that is greater than the actual revenue requirement for those plant additions, and this over-recovery will continue until the 2015 QIP additions make up for the 2014 shortfall. Peoples Gas' proposed treatment will create the potential for over-recovery if the actual 2014 additions are less than the forecast (which seems highly likely), without any risk of under-recovery if the actual 2014 additions are greater than the forecast. The estimate of the 2014 QIP additions in the determination of the base rate revenue requirement should be modified to mitigate this asymmetry.

Q. What do you recommend?

A. The 2014 QIP additions included in the test-year rate base should be modified to be more consistent with the actual experience in 2014 to date. This presents little risk of under-recovery to Peoples Gas because, based on its response to Staff Data Request DLH 11.01, Peoples Gas would then include the full revenue requirement of any 2014 QIP additions in excess of the balance included in rate base in the calculation of the first QIP Surcharge Percentage after the base rates in this case go into effect. The base rates established in the present case will be lower as a result of the reduction to the 2014 QIP additions included in the test-year rate base, but Peoples Gas will ultimately recover the full revenue requirement of the 2014 QIP additions through Rider QIP and will not be harmed by this reduction to base rates that go into effect at the beginning of 2015.

The actual AMRP additions in the first five months of 2014 were $22,645,000, or $4,529,000 per month. At that monthly rate, the annual 2014 AMRP additions will be $54,348,000. This is $172,561,000 less than the 2014 AMRP additions forecasted by Peoples Gas. I recommend that the 2014 QIP plant additions included in the test year rate base be reduced accordingly.

Q. What is the effect of reducing the 2014 QIP additions included in the 2015 test-year rate base?

A. The effect is to reduce the PGL 2015 test-year rate base by $186,500,000 (Schedule DJE PGL B-1). This adjustment also includes the effect of modifying the net cost of removal related to the QIP program, as addressed in the following section. Further, the PGL 2015 test-year depreciation expense is reduced by $4,569,000.

2. Cost of Removal

Q. How is the net cost of removing retired plant from service treated in the determination of rate base?

A. The cost of removal, what the Companies label "Dismantling Cost Net of Salvage" on their Schedules B-6, is charged against the depreciation reserve, thereby decreasing the depreciation reserve deducted from gross plant in service base and increasing the net rate base accordingly.

Q. What amounts of cost of removal is Peoples Gas forecasting for 2014 and 2015?

A. Referring to PGL Schedule B-6, it can be seen that Peoples Gas is forecasting cost of removal of approximately $50 million in each of those years. This is significantly in excess of the actual cost of removal incurred in recent years. In response to Data Request PGL AG 1.07, Peoples Gas attributed this increase to increased capital expenditures, especially as those increased expenditures relate to qualifying infrastructure plant.

Q. Does this satisfactorily explain the forecasted increase in cost of removal expenditures?

A. Only in part. On my Schedule DJE PGL B-2, I show the forecasted cost of removal in 2014 and 2015 after eliminating the cost of removal related to QIP property. The remaining forecasted cost of removal is $10,347,000 in 2014 and $12,120,000 in 2015. These amounts represent 132% of the 2014 retirements (exclusive of the QIP related retirements) and 79% of the 2015 retirements (again exclusive of the QIP related retirements). This is still well in excess of the cost of removal in relation to retirements in recent years.

Q. Are you proposing to modify Peoples Gas' forecasted cost of removal in 2014 and 2015?

A. Yes. Peoples Gas eliminated the cost of removal related to 2015 QIP property as part of its rate base adjustment on its Schedule B-2.1. I have already modified the cost of removal related to 2014 QIP property as part of my proposed adjustment to reduce the 2014 QIP additions included in the test-year rate base. The remaining forecasted cost of removal for 2014 and 2015 should be modified so that it is more consistent with the cost of removal in recent years.

In response to Data Request PGL AG 1.08, Peoples Gas provided the actual cost of removal and plant retirements in 2013. Based on that response, the cost of removal was 45.58% of retirements in 2013. This is more representative of the actual cost of removal in relation to retirements in recent years. Applying that ratio to the 2014 and 2015 retirements exclusive of the retirements related to QIP property results in a projected cost of removal of $3,582,000 for 2014 and $7,031,000 for 2015 (Schedule DJE PGL B-2). These amounts are $6,765,000 less than forecasted by Peoples Gas for 2014 and $5,089,000 less than forecasted by Peoples Gas for 2015. These adjustments to the forecasted cost of removal reduce the average 2015 test-year rate base by $9,309,000.

3. Retirement Benefits, Net

Q. What do the "Retirement Benefits, Net" included in rate base by the Companies represent?

A. The "Retirement Benefits, Net," as shown on the Companies' Schedule B-1, consist of two components. The first is the prepaid pension asset. The pension asset is mainly the effect of contributions to the pension fund being in excess of the periodic pension cost, or pension income, accrued pursuant to Statement of Financial Accounting Standards 87.

The second component is primarily the accrued liability for future post-retirement benefits other than pensions ("OPEB"), mainly health care costs. Pursuant to Statement of Financial Accounting Standards 106, the Companies must accrue for the payment of future post-retirement benefits other than pensions. To the extent that the accruals are greater than the actual cash disbursements, accrued liabilities will be reflected on the Companies balance sheets.

PGL and NS offset the accrued liability for OPEB against prepaid pensions in the calculation of the "Retirement Benefits, Net" that they include in their rate bases.

Q. Has this been an issue in the Companies' recent rate cases?

A. Yes. In Docket Nos. 07-0241 and 07-0242, the Companies did not take account of the accrued pension and OPEB balances in the determination of rate base. In response to testimony by Staff and intervenors proposing to deduct the accrued OPEB liabilities from rate base, the Companies responded that if the accrued OPEB liabilities are deducted from rate base, then the prepaid or accrued pension balances should also be recognized.

In Docket Nos. 09-0166, 09-0167, 11-0280, 11-0281, 12-0511, and 12-0512, the Companies offset the accrued liability for OPEB against prepaid pensions in the calculation of the "Retirement Benefits, Net" included in their rate bases. This was, in substance, the same treatment that the Companies are presenting in the present cases.

Q. What was the Commission's finding on this matter in those cases?

A. The Commission in all of those cases found that the accrued OPEB liability should be deducted from rate base but that the pension balances should not be recognized in the determination of rate base.

Q. How have you treated "Retirement Benefits, Net" in your determination of rate base?

A. Consistent with the Commission's findings in all recent cases, I have eliminated the pension balances from rate base, but have treated the accrued liability for post-retirement benefits other than pensions as rate base deductions. I have also eliminated the accumulated deferred income taxes related to the prepaid or accrued pensions The net effect of this adjustment is to reduce PGL "Retirement Benefits, Net" by $20,404,000 and related accumulated deferred income taxes by $16,867,000, resulting in a net reduction to the PGL rate base of $3,537,000 (Schedule DJE PGL B).

With regard to NS, the effect of my proposed adjustment is to reduce the "Retirement Benefits, Net" by $1,172,000 and to reduce the related accumulated deferred income taxes by $1,019,000, which results in a net reduction to the NS rate base of $153,000 (Schedule DJE NS B).

4. Accumulated Deferred Income Taxes - NOL

Q. Are you proposing any adjustments to the balance of accumulated deferred income taxes ("ADIT") deducted from gross utility plant in the determination of rate base?

A. Yes. ADIT represent the cumulative effect of book-tax timing differences, such as the deferred tax liability associated with the excess of tax accelerated depreciation over book depreciation. I am proposing one adjustment to the test-year balance of accumulated deferred income taxes.

As explained by Mr. Stabile, the Companies include a deferred tax asset for a net operating loss ("NOL") carry-forward as an offset to the balance of ADIT deducted from rate base. In effect, these deferred tax assets represent the cumulative effect of tax accelerated depreciation that the Companies were not able to use as a result of that accelerated tax depreciation driving the taxable income down to less than zero. The Companies are forecasting that the NOLs existing at the end of 2014 will be fully utilized in 2015. Thus, the deferred tax asset included in the average test-year rate base is equal to one half of the balance existing at the end of 2014.

In the responses to Data Request NS AG 1.14 and PGL AG 1.19, the Companies provided updates to the forecasts of taxable income for 2013 and 2014 that were used for the purpose of calculating the NOLs and related deferred tax assets existing as of the end of 2014. On my Schedules DJE NS B and DJE PGL B, I have reflected the impact of updating the forecasted NOLs based on those responses. The effect of such updates is to reduce the NS average 2015 rate base by $104,000 and to reduce the PGL average 2015 rate base by $5,544,000

C. OPERATING EXPENSES

1. Test-Year Employees

Q. Are you proposing modifications to the forecasted payroll costs included in the Companies' test-year operation and maintenance expenses?

A. Yes. I am proposing to reduce both the NS and PGL forecasts of the number of employees in the 2015 test year.

Q. Please explain your adjustment to the North Shore forecast of 2015 test-year employees.

A. NS is forecasting 178 full-time-equivalent employees ("FTE") for the 2015 test year. As of early 2014, the actual number of FTE was stable at about 166. The number of employees has been relatively steady through 2012 and 2013 and there is no discernible upward trend in the number of employees. Therefore, the number of employees reflected in the determination of NS test-year operation and maintenance expenses should be reduced.

Based on the response to Data Request NS AG 11.03, the actual average number of NS FTE in the first five months of 2014 was approximately 166, with little variation. I recommend that the NS 2015 test-year payroll expense be adjusted to reflect 166 FTE rather than the NS forecast of 178, as the forecasted increases in the number of employees are not taking place.

My proposed adjustment to the NS test-year employee complement reduces the forecasted test-year operation and maintenance expense by $670,000 and related payroll taxes by $48,000 (Schedule DJE NS C-1).

Q. Please explain your adjustment to the Peoples Gas forecast of 2015 test-year employees.

A. PGL is forecasting 1,356 full time equivalent employees for the 2015 test year. Based on the response to Data Request PGL AG 11.03, the actual average number of FTE in the first five months of 2014 was about 1,302. This represents a slight increase in the number of employees from 2012 and early 2013. However, it is slightly *lower* than the average level of FTE in the second half of 2013. In addition, the actual number of FTE in April and May of 2014 was slightly lower than the FTE in the first three months of 2014. Based on these data, the number of FTE is not increasing as forecasted by PGL.

I recommend that the PGL 2015 test-year payroll expense be adjusted to reflect 1,302 FTE, the average for the first five months of 2014, rather than the PGL forecast of 1,356. Based on the experience in the second half of 2013 and the first five months of 2014, the forecasted increases in the number of employees are not taking place.

My proposed adjustment to the PGL test-year employee complement reduces the forecasted test-year operation and maintenance expense by $2,779,000 and related payroll taxes by $188,000 (Schedule DJE PGL C-1).

2. Medical Benefits

Q. Have you analyzed the forecasted test-year employee benefits expenses?

A. Yes. The test-year employee benefits are summarized on the Companies' Part 285 Schedules C-11.3, with additional details on NS Exhibit 12.1 and PGL Exhibit 12.1.

Q. Are you proposing any adjustments to the Companies' forecasts of 2015 test-year employee benefits expenses?

A. Yes. One of the major components of employee benefits is medical benefits for current employees. As can be seen on NS Exhibit 12.1 and PGL Exhibit 12.1, both Companies are projecting substantial increases in the medical benefits costs (Account 926060) from 2012 to the 2015 test year. While some increase in the level of this expense is reasonable, the Companies have not justified the magnitude of the increases being forecasted.

Q. Please explain your adjustment to the North Shore forecast of 2015 test-year medical benefits.

A. Referring to NS Exhibit 12.1, it can be seen that NS is forecasting an increase in medical benefits costs from $1,329,000 in 2012 to $1,927,000 in 2015, an increase of 45%. Based on the response to Data Request NS AG 1.42, the medical costs actually *decreased* from $1,329,000 in 2012 to $1,271,000 in 2013. Thus, the forecasted 2015 medical benefits costs of $1,927,000 in 2015 represent an increase of 52% over the actual 2013 medical benefits costs. While it may not be unreasonable to expect some increase in medical benefits costs from 2013 to 2015, I do not believe that a forecasted increase of 52% over a two-year period is reasonable.

Q. How do you propose to adjust the forecasted NS 2015 test-year medical benefits costs?

A. I recommend that a reasonable escalation factor be applied to the actual 2013 medical benefits costs to project the 2015 test-year costs. On NS Exhibit 12.0, Page 6, North Shore explained that its forecasted 2013 medical cost per FTE was escalated by 4.9% for 2014 and 8.0% for 2015 to determine the projected rate for 2015. In Data Request PGL AG 1.51, the Companies were asked to provide supporting documentation for the projected 8% increase from 2014 to 2015. The response was provided in a one-sheet attachment titled “2013 rate development methodology and assumptions,” with three lines showing an “Annual trend” of “8.5%, 6% prescription drug, and 5% dental.” The cover sheet explained that the 8% trend was a blend of the 8.5% and the 6% prescription drug escalation rates. In my opinion, this is not adequate justification for an increase of 8% from 2014 to

2015. Therefore, I recommend that an annual escalation rate of 4.9% be applied to the actual 2013 medical benefits for two years to project the 2015 test-year medical benefits expense

Q. What is the effect of your proposed modification to the projection of NS 2015 test-year medical costs?

A. Referring to Schedule DJE NS C-2, I have calculated 2015 test-year medical benefits costs of $1,399,000. This is $528,000 less than the medical benefits costs projected by NS. This adjustment to medical costs results in a reduction of $418,000 to medical benefits costs charged to 2015 test-year operation and maintenance expenses.

Q. Please explain your adjustment to the Peoples Gas forecast of 2015 test-year medical benefits.

A. Referring to PGL Exhibit 12.1, it can be seen that PGL is forecasting an increase in medical benefits costs from $9,059,000 in 2012 to $13,892,000 in 2015, an increase of 53%. Based on the response to Data Request PGL AG 1.50, the medical costs did increase from $9,059,000 in 2012 to $9,681,000 in 2013, but this is nowhere near the average annual rate of increase from 2012 to 2015 projected by PGL. The forecasted 2015 medical benefits costs of $13,892,000 in 2015 still represents an increase of 43% over the actual 2013 medical benefits costs. While it may not be unreasonable to expect some increase in medical benefits costs from 2013 to 2015, I do not believe that a forecasted increase of 43% over a two-year period is reasonable.

Q. How do you propose to adjust the forecasted PGL 2015 test-year medical benefits costs?

A. Again, I recommend that a reasonable annual escalation factor be applied to the actual 2013 medical benefits costs to project the 2015 test-year costs. For the reasons described above, I recommend that a 4.9% annual escalation rate be applied to the actual 2013 medical benefits for the purpose of projecting the 2015 test-year medical benefits expense.

Q. What is the effect of your proposed modification to the projection of PGL 2015 test-year medical costs?

A. Referring to Schedule DJE PGL C-2, I have calculated 2015 test-year medical benefits costs of $10,653,000. This is $3,239,000 less than the medical benefits costs projected by PGL. This adjustment to medical costs results in a reduction of $2,189,000 to medical benefits costs charged to 2015 test-year operation and maintenance expenses.

3. IBS O&M Cross-Charges

Q. Do the Companies' 2015 test-year operation and maintenance ("O&M") expenses include charges from Integrys Business Support, LLC ("IBS")?

A. Yes. As explained in NS Exhibit 13.0 and PGL Exhibit 13.0, IBS provides services to all subsidiaries of Integrys, including NS and PGL. The total forecasted 2015 test-year O&M cross-charges from IBS to NS are $31.8 million. The total forecasted 2015 test-year O&M cross-charges from IBS to PGL are $215.7 million. (Both of these amounts include employee benefits costs for direct NS and PGL employees.) The forecasted 2015 IBS O&M cross-charges to NS represent an increase of 13.4% over the actual 2012 O&M cross-charges. The forecasted 2015 IBS O&M cross-charges to PGL represent an increase of 27.9% over the actual 2012 O&M cross-charges.

Q. Are you proposing any adjustments to the forecasted IBS cross-charges included in the Companies' 2015 test-year operation and maintenance expenses?

A. Yes. The Companies have provided details of the cost elements included in the O&M cross-charges. In the following testimony, I propose adjustments to certain of those cost elements.

a. Labor

Q. What amount of labor expense is included in the forecasted 2015 test-year O&M cross-charges from IBS to North Shore?

A. The forecasted NS 2015 test-year O&M includes $7,630,000 of labor expense charged by IBS.

Q. Is this forecasted labor expense reasonable?

A. No. The forecasted $7,630,000 expense represents an increase of 17% over the actual 2012 expense. Based on the response to Data Request NS AG 1.51, the actual IBS cross charged labor expense to NS *decreased* from $6,521,000 to $6,330,000 in 2013. The response to Data Request NS AG 7.05 shows the cross-charged labor expense to NS in the first four months of 2014 was actually less than the expense in the corresponding period in 2013. Based on this actual experience, the projected increase in labor expense to the 2015 test year is overstated and should be modified.

Q. What do you recommend?

A. I recommend that the actual 2013 expense be used as a base to project the 2015 test-year labor expense, and I further recommend that the 2014 IBS labor expense charged to North Shore be assumed to be the same as the 2013 expenses. I believe that this is a reasonably conservative assumption, as the expense in the first four months of 2014 was actually lower than the expense in the first four months of 2013.

The actual labor expense in 2013 was $6,331,000. I am assuming that the expense will be the same in 2014. The response to Data Request NS AG 3.01 shows that the forecast of 2015 cross-charged labor expense includes the effect of $740,000 of wage rate increases from 2012 to 2015. This translates into an average increase in wage rates of 3.78% per year. Application of this increase to the assumed 2014 labor expense of $6,331,000 results in a projected 2015 labor expense of $6,570,000 (Schedule DJE NS C-3). This is $1,060,000 less than the $7,630,000 of labor expense forecasted by NS. The NS test-year operation and maintenance expense should be adjusted accordingly.

Q. What amount of labor expense is included in the forecasted 2015 test-year O&M cross-charges from IBS to Peoples Gas?

A. The forecasted PGL 2015 test-year O&M includes $45,781,000 of labor expense charged by IBS.

Q. Is this forecasted labor expense reasonable?

A. No. The forecasted $45,781,000 expense represents an increase of 21% over the actual 2012 expense. Based on the response to Data Request PGL AG 1.59, the actual IBS cross-charged labor expense to PGL increased by only 0.5% from 2012 to 2013, well below the rate of increase forecasted by PGL. The response to Data Request PGL AG 7.07 shows an increase in the cross-charged labor expense to PGL in the first four months of 2014 over the corresponding period in 2013, but at a lower rate than the increase forecasted by PGL from the actual 2013 labor expenses to 2014. Based on this actual experience, the projected increase in labor expense to the 2015 test year is overstated and should be modified.

Q. What do you recommend?

A. I recommend that the actual 2013 expense be used as a base to project the 2015 test-year labor expense. The actual labor expense in 2013 was $37,895,000. The response to Data Request PGL AG 3.10 shows that the forecast of 2015 cross-charged labor expense includes the effect of $4,281,000 of wage rate increases from 2012 to 2015. This translates into an increase of 3.79% per year. Application of this increase in both 2014 and 2015 to the actual 2013 labor expense of $37,895,000 results in a projected 2015 labor expense of $40,818,000 (Schedule DJE PGL C-3). This is $4,963,000 less than the $45,781,000 of IBS labor expense forecasted by PGL. The PGL test-year operation and maintenance expense should be adjusted accordingly.

b. Incentive Compensation

Q. What is your understanding of the Commission's general practice with regard to the inclusion of incentive compensation expense in the revenue requirements of regulated utility companies?

A. It is my understanding that the Commission has generally allowed the recovery of incentive compensation only when it is demonstrated that such compensation operates so as to provide identifiable benefits to the utility's customers. (See, for example, Docket Nos. 07-0241, 07-0242, 09-0166, 09-0167, 11-0281, 11-0282, 12-0511, and 12-0512, North Shore Gas Company and Peoples Gas Light and Coke Company.)

Q. What amounts of incentive compensation have the Companies included in test-year operation and maintenance expenses?

A. NS includes $1,893,000 of incentive compensation in 2015 test-year operation and maintenance expenses (response to Data Request NS AG 1.25). PGL includes $11,709,000 of incentive compensation in 2015 test-year operation and maintenance expenses (response to Data Request PGL AG 1.30). These incentive compensation expenses include both incentive compensation incurred directly by the Companies and incentive compensation billed by IBS.

Q. Is all of this incentive compensation expense properly recoverable from ratepayers?

A. No. To the extent that incentive compensation is related to goals that have not been shown to benefit ratepayers, the incentive compensation related to those goals should not be recoverable from ratepayers. The achievement of goals such as quality of service, reliability, public safety, reducing absenteeism, and cost containment are at least arguably in the interest of ratepayers. However, incentive compensation based on financial goals such as maximizing profitability and growth, increasing earnings per share, or increasing return on equity is beneficial only to shareholders, and not properly recoverable from ratepayers. For example, if all else is equal, higher rates will result in higher revenues, which in turn will result in higher earnings and return on equity. Thus, including incentive compensation related to such goals in the revenue requirement would, in effect, require customers to reward utility management on a contingency basis for getting them to pay higher rates. If the incentive compensation program is successful in increasing earnings, the shareholders should be happy to reward management accordingly and absorb the cost of the program. As shareholders are the beneficiaries of the attainment of financial goals such as increases to earnings and return on equity, it should be those shareholders, not customers, who bear the cost of the incentive compensation related to the achievement of such financial goals.

The incentive compensation included in NS and PGL test-year operation and maintenance expense includes the cost of Executive Incentive Plan and Omnibus Incentive Compensation Plan (stock options, etc.). Based on NS Exhibit 10.0 and PGL Exhibit 10.0, the Executive Incentive Plan has a 70% weighting on an earnings-per-share (EPS) measure and 30% weighting on operational measures such as safety and customer satisfaction. The Omnibus Incentive Compensation Plan does not include any customer-oriented goals.

Q. What do you recommend?

A. The cost of the Omnibus Incentive Compensation Plans should be entirely eliminated from the Companies' revenue requirements. The 70% of the costs of the Executive Incentive Plan not associated with operational goals should also be eliminated from the Companies' revenue requirements. These adjustments result in a $781,000 reduction to NS test-year operation and maintenance expense (Schedule DJE PGL C-3) and a $4,903,000 reduction to PGL test-year operation and maintenance expense (Schedule DJE PGL C-3).

c. IBS Benefits Billed

Q. Do test-year operation and maintenance expenses include employee benefit costs billed from IBS?

A. Yes. As shown on NS and PGL Schedules C-11.3, IBS benefits billed are included in total employee benefits expense. The NS 2015 test-year IBS benefits billed expense is $1,868,000, and the PGL 2015 test-year IBS benefits billed expense is $11,250,000. The details of the IBS benefits billed are shown on NS Exhibit 12.2 and PGL Exhibit 12.2. As can be seen on these exhibits, the 2015 IBS benefits allocated to NS represent 6.6% of the total 2015 IBS benefits expense $28,300,000, and the 2015 IBS benefits allocated to PGL represent 39.8% of the total 2015 IBS benefits expense.

Q. Are you proposing to adjust the forecasted IBS benefits expense allocated to NS and PGL?

A. Yes. I am proposing two adjustments. First, I am proposing to modify the forecast of medical benefits expense. Second, I am proposing to modify the percentages of IBS benefits expenses charged to NS and PGL.

Q. Please explain your proposed adjustment to the forecast of IBS medical benefits costs.

A. This is similar to the adjustments to NS and PGL medical expenses described earlier in this testimony. Referring to NS and PGL Exhibits 12.1, it can be seen that IBS medical benefits costs are forecasted to increase from $9,808,000 in 2012 to

$12,552,000 in 2015, an increase of 28%. Based on the response to Data Request PGL AG 1.53, the medical costs actually *decreased* from $9,808,000 in 2012 to $9,554,000 in 2013. Thus, the forecasted 2015 medical benefits costs of $12,552,000 in 2015 represent an increase of 31% over the actual 2013 medical benefits costs. While it may not be unreasonable to expect some increase in medical benefits costs from 2013 to 2015, I do not believe that a forecasted increase of 31% over a two-year period is reasonable.

Q. How do you propose to adjust the forecasted IBS 2015 test-year medical benefits costs?

A. Again, I recommend that a reasonable escalation factor be applied to the actual 2013 medical benefits costs to project the 2015 test-year costs. For the reasons described in my testimony above regarding NS and PGL medical benefits costs, I recommend that a 4.9% annual escalation rate be applied to the actual 2013 medical benefits for the purpose of projecting the 2015 test-year medical benefits expense

Q. What is the effect of your proposed modification to the projected IBS 2015 test-year medical costs?

A. Referring to my Schedules DJE NS C-3 and DJE PGL C-3, I have calculated 2015 test-year medical benefits costs of $10,513,000. This is $2,039,000 less than the medical benefits costs projected by the Companies for IBS.

Q. Please explain your proposed adjustment to the percentages of IBS benefits expenses charged to NS and PGL.

A. NS Exhibit 12.2 and PGL Exhibit 12.2 show the allocation of IBS benefits expenses to NS and PGL. Both of these exhibits show increases from the actual 2012 allocation percentages to the forecasted 2015 allocation percentages, with the greatest increases taking place from 2013 to 2014. In Data Requests AG NS 1.48 and AG PGL 1.56, the Companies were asked to explain the forecasted increases in the allocation percentages from 2013 to 2014. The Companies provided a brief description of the method used to allocate IBS benefits expenses to NS and PGL and also provided what they described as the actual allocation ratios for 2013, stating that the allocation percentages from IBS to NS and PGL have "not changed significantly from actual 2013 to forecast 2014."

The allocation percentages for 2013 in the responses to Data Requests AG NS 1.48 and AG PGL 1.56 are inconsistent with the actual allocation percentages in the responses to Data Requests AG NS 1.45 and AG NS 1.53. In the response to AG NS 1.48, the Company stated that the allocation percentage for NS in 2013 was 6.5%. The actual allocation percentage in the response to AG NS 1.45 is 5.7%. The forecasted allocation percentage of 6.5% for 2014 is a significant increase from the actual 2013 allocation percentage, which NS has not explained.

In the response to AG PGL 1.56, the Company stated that the allocation percentage for PGL in 2013 was 39.0%. The actual allocation percentage in the response to AG PGL 1.53 is 34.1%. Again, the forecasted allocation percentage of

39.0% for 2014 is a significant increase from the actual 2013 allocation percentage, which PGL has not explained.

The actual 2013 allocation percentages for 2013 represent decreases from the actual 2012 allocation percentages. (The Company had forecasted decreases from 2012 to 2013, but the actual decreases were greater than forecasted.) The Companies have not justified the jumps in the allocation percentages from 2013 to the forecasted 2014 allocation percentages, which approximate the forecasted 2015 test-year allocation percentages. Therefore, the forecasted 2015 test-year allocation percentages should be modified.

Q. What do you recommend?

A. I recommend that the actual 2013 allocation percentages be used to allocate the IBS benefits expense to NS and PGL. The actual 2013 allocation percentages are 5.7% for NS and 34.1% for PGL.

Q. Please summarize the effect of your proposed adjustments to the IBS benefits expenses allocated to NS and PGL.

A. My proposed modifications reduce the NS 2015 test-year operation and maintenance expense by $360,000 (Schedule DJE NS C-3) and the PGL 2015 test-year operation and maintenance expense by $2,231,000 (Schedule DJE PGL C-3).

d. Postage Expense

Q. Does IBS allocate postage expense to NS and PGL?

A. Yes. NS test-year operation and maintenance expenses include $914,000 of postage expense allocated from IBS. PGL test-year operation and maintenance expenses include $4,799,000 postage expense allocated from IBS (response to Data Request NS AG 3.03).

Q. Are you proposing to adjust the test-year postage expenses?

A. Yes. The forecasted 2015 postage expense for NS represents an increase of 38% over the actual postage expense of $648,000 in 2013. The forecasted 2015 postage expense for PGL represents an increase of 20% over the actual postage expense of $4,170,000 in 2013. Projected increases of this magnitude over two years are not reasonable.

It would not be unreasonable to include a small allowance for increases in postage rates from 2013 to 2015, but such an allowance should be no more than 10%, based on annual increases in postage rates in recent years. I have calculated that escalating the actual 2013 postage expense by 10% would result in a reduction of $201,000 to the NS forecasted 2015 test-year postage expense (Schedule DJE NS C-4) and $212,000 to the PGL forecasted 2015 test-year postage expense (Schedule DJE PGL C-4).

e. Legal Expense

Q. Are you proposing to adjust the legal expense charged by IBS to either of the Companies?

A. Yes. NS test-year operation and maintenance expenses include $618,000 of legal expense allocated from IBS. This represents an increase of 61% over the actual legal expense of $383,000 in 2013. In response to Data Request NS AG 1.55, NS explained that the increase "is based on the assumption that outside legal fees will increase since they have remained flat since 2008."

This does not strike me as a logical explanation for the forecasted increase in legal expenses. If anything, that seems like more of an explanation of why there should be a forecast of no increase in legal fees.

Q. How are you proposing to adjust the forecast of 2015 legal fees charged from IBS to NS?

A. NS has not justified the forecasted increase in legal expenses. I recommend that test-year legal expenses reflect the average actual legal fees for the years 2012 and 2013 (which approximates the five-year average for the years 2009 – 2013). The average actual legal expense for 2012 and 2013 was $446,000 (Schedule DJE NS C-4). This is $172,000 less than the 2015 test-year legal expense forecasted by NS. I recommend that NS 2015 test-year operation and maintenance expenses be reduced accordingly.

f. ICE Depreciation/ROA

Q. Do test-year expenses include depreciation and return on assets ("ROA") related to IBS hardware and software for the Integrys Customer Experience ("ICE") project?

A. Yes. The ICE project is described in NS Exhibit 13.0 and PGL Exhibit 13.0. As shown in the response to Staff Data Request DLH 5.07, Attachment 1, the budgeted depreciation and ROA on the ICE project is forecasted to increase from $11,000 in 2012 to $1,378,000 in 2015 for NS and from $56,000 in 2012 to $7,263,000 in 2015 for PGL.

Q. Are the depreciation and ROA related to the ICE project increasing as forecasted?

A. No. The response to Staff Data Request PGL DLH AG 5.07 shows that ICE depreciation/ROA charged to NS in 2013 was only $52,000. The actual expense in the first four months in 2014 was $40,000 (response to Data Request PGL AG 11.07), which translates into an annualized non-labor ICE expense level of $120,000.

The response to PGL DLH AG 5.07 shows that ICE depreciation/ROA charged to PGL in 2013 was only $275,000. The actual expense in the first four months in 2014 was $209,000 (response to Data Request PGL AG 11.07), which translates into an annualized non-labor ICE expense level of $627,000.

Q. Are you proposing to adjust the forecasted 2015 test-year non-labor ICE expenses?

A. Yes. Based on the information provided by the Companies, the forecasted increases in the ICE depreciation/ROA are not taking place at the forecasted rates. For the purpose of quantifying my proposed adjustments to the forecasted ICE depreciation/ROA, I have relied on the annualized level expenses over the first four months of 2014. On Schedule DJE NS C-4, I have calculated a reduction of $1,258,000 to 2015 test-year ICE depreciation/ROA allocated from IBS to NS. On Schedule DJE PGL C-4, I have calculated a reduction of $6,636,000 to 2015 test-year non-labor ICE depreciation/ROA allocated from IBS to PGL. These adjustments should be updated as more information in 2014 becomes available, but unless the Companies can better document and justify the forecasted increases in 2015 ICE depreciation/ROA, there should be a substantial reduction to the level of those expenses included in test-year operation and maintenance.

g. Other Non-Labor ICE Expenses

Q. Does the 2015 test year also include non-labor ICE expenses other than ROA/Depreciation charged from IBS to NS and PGL?

A. Yes. The response to Data Request NS AG 1.54 shows an increase of non-labor ICE expense from $989,000 in 2012 to a forecasted level of $1,504,000 in 2015, an increase of $515,000. The response to Data Request PGL AG 1.62 shows an increase of non-labor ICE expense from $5,140,000,000 in 2012 to a forecasted level of $9,057,000 in 2015, an increase of $3,917,000.

Q. Are these increases taking place as forecasted?

A. No. The response to Data Request NS AG 7.06 shows that non-labor ICE expenses charged to NS actually decreased from $989,000 in 2012 to $178,000 in 2013. The actual expenses in the first four months in 2014 were $83,000, which translates into an annualized non-labor ICE expense level of $249,000, still well short of the actual 2012 expense.

The response to Data Request PGL AG 7.08 shows that non-labor ICE expenses charged to PGL decreased from $5,140,000 in 2012 to $954,000 in 2013. The actual expenses in the first four months in 2104 were $443,000, which translates into an annualized non-labor ICE expense level of $1,329,000, still well short of the actual 2012 expense.

Q. Are you proposing to adjust the forecasted 2015 test-year non-labor ICE expenses?

A. Yes. Based on the information provided by the Companies, the forecasted increases in the non-labor ICE expenses are not taking place. For the purpose of quantifying my proposed adjustments to the forecasted non-labor ICE expenses, I have relied on the annualized level expenses over the first four months of 2014. On Schedule DJE NS C-4, I have calculated a reduction of $1,255,000 to 2015 test-year non-labor ICE expenses allocated from IBS to NS. On Schedule DJE PGL C-4, I have calculated a reduction of $7,729,000 to 2015 test-year non-labor ICE expenses allocated from IBS to PGL. These adjustments should be updated as more information in 2014 becomes available, but unless the Companies can better document and justify the forecasted increases in 2015 non-labor ICE expenses, there should be a substantial reduction to the level of those expenses included in test-year operation and maintenance.

Q. Does this conclude your direct testimony?

A. Yes.